

CEO Compensation and Shareholder Value Orientation Among Large US Firms*

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Abstract: The rise of shareholder value orientation among US firms has been studied extensively during the past few decades as a key component of financialisation. The firm-level mechanisms of how such institutional changes have affected firm behaviours are not well understood, however. This study examines the relationship between the shareholder value orientation of firms and financial rewards for the executive managers who run those companies. Using compensation data for 290 CEOs for an 11-year period, I demonstrate that CEOs at the firms with the appearance of shareholder value orientation – such as monitoring and incentive-alignment mechanisms – receive greater compensation than non-shareholder-value-orientation CEOs. Moreover, when the firms strengthen the appearance of shareholder value orientation, CEO pay increases the subsequent year. This suggests that firms adopt monitoring and incentive-alignment mechanisms in order to gain the appearance of shareholder value orientation rather than to curb executive compensation. By employing such symbolic management tactics, top managers at such firms earn greater legitimacy, a better reputation, and a higher valuation of the firms and executive talent. The findings suggest that executive compensation has played an important role in providing incentives for top managers to make strategic decisions that conform to the shareholder value maximisation principle.

I INTRODUCTION

Scholars have documented financialisation as a profound transformation of the American economy that occurred during the past three decades (Davis, 2009; Krippner, 2005, 2011; Tomaskovic-Devey and Lin, 2011). Whereas various institutional backgrounds that led to financialisation – the increasing

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importance of financial firms and the increasing involvement of non financial firms in financial activity – have been extensively studied (Davis, 2009; Krippner, 2011; Tomaskovic-Devey and Lin, 2011), the exact mechanisms that underlie these processes remain unclear. The main reason is because most of the discussions so far have relied on the analyses at the level of economies (Hacker and Pierson, 2010; Krippner, 2005) or industries (Tomaskovic-Devey and Lin, 2011), whereas the scholars have increasingly recognised the need for firm-level research that explores how firms changed strategies and structure as both the causes and consequences of financialisation (Krippner, 2005).

This study examines firm-level dynamics that contributed to the financialisation of the US economy. More specifically, this paper analyses the relationship between shareholder value orientation – a key component of financialisation in the contemporary context – and the financial rewards for corporate executives. Shareholder value orientation is the management principle that emerged during the 1980s and 1990s as a dominant model of corporate governance in the American business community (Dobbin and Jung, 2010; Fligstein and Shin, 2007; Goldstein, 2012; Lazonick and O’Sullivan, 2000). As a collective norm or ideology, shareholder value orientation urges top managers to focus solely on maximising financial returns for corporate investors. The increased focus on financial metrics, such as share prices and dividends, is an integral part of financialisation, in which non financial firms reallocate their investment and business operations away from traditional production processes and increasingly towards finance-related activities (Krippner, 2005; Tomaskovic-Devey and Lin, 2011). Understanding how such non financial firms have become increasingly more finance-oriented in their strategies and structure requires an analysis of the incentives and rewards for the top decision-makers at these firms. This study shows that (1) executive managers are financially rewarded for espousing shareholder value principles; (2) they adopt certain kinds of practices and strategies that they know will signal the board and investors that they conform with shareholder value principles such as monitoring and incentive alignment mechanisms, and; (3) the adoption of these practices and strategies increase their legitimacy and approval, and in return their compensation, regardless of the quality of their performance.

Compensation for executive managers at publicly traded companies has attracted much attention from scholars in various disciplines, including economics (Jensen and Murphy, 1990a; Hall and Murphy, 2003), sociology (Allen, 1981; DiPrete, Eirich, and Pittinsky, 2010), and management (Devers, Cannella, Reilly, and Yoder, 2007; Finkelstein, Hambrick, and Cannella, 2009). Despite a large volume of research, a fundamental question is yet unanswered: Why is executive compensation still going unchecked? In other

words, why do CEOs at poorly performing companies continue to receive hefty pay, as exorbitant pay packages for executives at banks and automobile companies with poor performance have often become headline news in recent years? This has puzzled critics (e.g., Crystal, 1991) and academics (e.g., Jensen and Murphy, 1990b) who have advocated reforms that would have arguably corrected the executive pay system. Their suggestions were based on two principles: more effective monitoring of executive behaviours and tighter alignment of executive incentives to those of shareholders. According to this logic, firms should strengthen the monitoring system to ensure that the executives do not abuse their power to influence the pay settings. Boards of directors, and more increasingly these days, large institutional investors, are expected to perform such monitoring. Incentives are the other side of the story. Financial economists have argued that executive compensation should be designed so that it would align the incentives of the managers to those of the owners. Only when the managers see their own money at risk, would they have the incentives not to waste shareholders' money on inefficient, wasteful projects and instead focus their efforts on maximising shareholder value, which is tied to their own personal wealth.

In this paper, I show that the two principles of effective monitoring and incentive alignment have failed to prevent the continuing rise of executive compensation and the decoupling of pay from performance. Drawing insights from institutional theory (DiMaggio and Powell, 1983; Meyer and Rowan, 1977), I argue that firms adopt monitoring mechanisms and incentive compensation policies, not because of the inherent efficiency benefits of such mechanisms, but because of the institutional pressure from influential external constituents such as activist investors, investment fund managers, and security analysts. Monitoring and incentives not only fail to prevent executive entrenchment and excessive pay awards, but the adoption of monitoring and incentive mechanisms make the firms appear in conformity to shareholder preferences and grant them more legitimacy in the eyes of the investors and the board. The competencies of the executives at such firms are favourably evaluated. To reward and to retain such executives within the company, the firms award them greater compensation packages. As a consequence, the appearance of effective monitoring and incentive alignment plays a role in justifying the surge of pay for those who were deemed to deserve it, rather than functioning as a curb on executive excess.

To empirically demonstrate this, I analyse compensation data for 290 CEOs from non financial US firms for the period of 1996–2006. Firms that adopted monitoring mechanisms and incentive compensation plans, following the diagnosis from shareholder advocates and financial economists, are identified by examining the board composition, institutional investor

ownership, and the structure of executive compensation packages. I label these firms as *shareholder value orientation firms*, because these characteristics together aim to maximise shareholder value and curb managerial entrenchment. Contrary to financial economists' argument, the results indicate that CEO compensation is greater at firms with a stronger display of shareholder value orientation than at non-shareholder-value firms. Also inconsistent with financial economists' prediction is that executive pay is not more sensitive to firm performance at shareholder value orientation firms than at non-shareholder-value firms. These findings suggest that something other than effective monitoring and incentive alignment is at work. Consistent with the alternative view that I develop in this paper, firms that appear to strengthen the shareholder value orientation – namely by enhancing monitoring and incentive pay systems – increase the CEO pay in the subsequent period. Shareholder value mechanisms did not curb the surge of pay; rather, it preceded the CEO pay raise.

This study contributes to organisational theory and economic sociology by demonstrating the impact of the transformation of corporate control that occurred during the past few decades (Davis, Diekmann, and Tinsley, 1994; Davis and Thompson, 1994; Fligstein, 2001; Useem, 1996). Scholars who are interested in the issue of corporate control have observed the rise of shareholder value as the primary goal of the public corporation (Fligstein, 2001; Lazonick and O'Sullivan, 2000). For the advocates of shareholder primacy, excessive executive pay has been a frequent target of criticism. Along with corporate scandals, exorbitant CEO pay and the lack of pay-for-performance have become symbols of executive excess and managerial entrenchment, which have provided an opportune rationale for shareholder advocates and activist investors to demand managerial accountability and shareholder rights. If shareholder primacy should have weakened executive power, why has executive pay continued to rise even at firms with poor performance? This paper provides an answer: executive compensation played an important role in rewarding the managers based on their appearance of conformity to shareholder value mandates. CEOs who adopted governance reform programmes were handsomely rewarded, regardless of actual firm performance. While organisational scholars have illustrated the role of external constituencies – such as the government, investors, and stock analysts – in this process (e.g., Useem, 1996; Zorn, 2004; Zuckerman, 2000), it remained unclear what roles top managers played. In this paper, I argue that top managers played an active role and strategically used symbolic management tactics to gain shareholders' approval and improve legitimacy in executive compensation policies. These managers were financially rewarded for doing this.

II SHAREHOLDER VALUE ORIENTATION AND CEO COMPENSATION: FINANCIAL ECONOMIC PERSPECTIVE

So far, the academic literature on executive compensation has been dominated by a financial economic perspective, particularly, an agency theory perspective (Fama and Jensen, 1983; Jensen and Meckling, 1976). Agency theory starts from Berle and Mean's (1932) classic observation that the ownership of large, modern corporations is largely separated from the actual day-to-day control of the organisation. Professional managers who are not owners of the firm are appointed to control the capital and assets of the owners. In this situation, managers, as agents of the owners, have incentives to use the assets in ways that are not necessarily in the best interests of the owners. Agency theorists apply the economic view of human behaviour that managers are apt to seek their own self-interests, even at the cost of shareholder wealth. Examples of such discretionary activities that are wasteful to shareholders include managers' obsession to acquire unrelated businesses to build unprofitable conglomerates and their exercise of influence over the process of compensation setting.

Agency theory suggests that firms adopt governance mechanisms in order to mitigate this problem and to reduce the inefficiencies. Two types of governance mechanisms are widely proposed. First, executive behaviours need to be closely monitored to ensure that they act in a way that would maximise shareholder wealth. A board of directors is traditionally responsible for such a monitoring task. Since shareholders do not and cannot actively involve themselves in the day-to-day operations of the company, they elect directors to monitor the business, advise the management, and advocate shareholder interests. Their primary duties and rights include the decisions about the appointment, compensation, and termination of executive managers. In sum, a board of directors is considered one of the most important governance mechanisms to mitigate the agency problem and to advocate shareholder value, at least in theory.

To strengthen the monitoring power of boards of directors, agency theorists and shareholder value advocates argue for board independence, which in practice means appointing more outsiders to the board (Fama and Jensen, 1983). The advocates maintain that outsiders are better able to monitor, evaluate, and challenge managers than are insiders; thus, boards composed largely of outsiders function as an effective monitoring mechanism. Therefore, agency theorists suggest that firms with more powerful, independent boards would more effectively prevent excessive executive pay packages and more tightly link executive pay to actual performance, compared to firms with weaker boards. In a meta-analysis of 219 studies, van Essen,

Otten, and Carberry (2012) showed that the proportion of outsiders on the board is positively associated with the sensitivity of CEO pay to firm performance.

Large institutional investors constitute another monitoring mechanism that has gained power in recent decades (Useem, 1996). The percentage of corporate shares held by institutional investors such as pension funds, mutual funds, and insurance companies increased from 25 per cent in 1980 to 50 per cent by the early 1990s and to nearly 60 per cent by 2000 (Zorn, Dobbin, Dierkes and Kwok, 2005). Compared to scattered individual investors, large institutional investors have a greater ability to monitor corporate operations and managerial behaviour, communicate with management and the board, and when necessary, coordinate actions of intervention. One of the ways in which they pressure management is to sponsor shareholder resolutions on topics such as corporate governance and firm strategy. Executive compensation has become the most frequently addressed issue in such resolutions (Gillan and Starks, 2007). As outsider monitors, large institutional owners may affect the amount and the structure of executive compensation. In a study of executive compensation at nearly 2,000 firms, Hartzell and Starks (2003) found that the concentration of institutional ownership is negatively associated with the level of executive pay and positively associated with the sensitivity of pay to performance. In the meta-analysis mentioned previously, van Essen *et al.* (2012) showed that institutional ownership is positively related to performance-pay sensitivity for CEOs.

Whereas monitoring by either boards or institutional investors is one kind of mechanism that mitigates the agency problem and curbs executive compensation, the other important mechanism is to align managerial incentives with shareholder interests. To achieve incentive alignment, firms introduce compensation packages that link managerial pay to performance. There are a few ways to design a pay package to reflect performance. Commonly, executive bonuses have specific terms and conditions that determine the amount based on the future performance of the firm, often in accounting and financial performance metrics. Firms can directly award company stocks, often with certain restrictions, so that executives can actually become shareholders. Also popular are stock options, which provide executives with the right to purchase company stocks at a pre-determined price at pre-determined time in the future, thereby giving executives incentives to boost stock price (Murphy, 1999).

Agency theorists have long advocated greater use of pay packages that align managerial incentives with shareholder value (Hall and Murphy, 2003; Jensen and Murphy, 1990b). The theory implies that if the incentive alignment is effective, the level of executive pay should be on average

lower after controlling for firm performance. This is because most of the variations in pay should be accounted for by variations in performance, so there is relatively little room for managerial excess. Another implication of incentive alignment is that executive compensation is tied to firm performance. Many academic studies based on the agency theory perspective measured the sensitivity of executive pay to firm performance (Hall and Liebman, 1998; Jensen and Murphy, 1990a; Murphy, 1999). An influential study by Jensen and Murphy (1990a) reported that the pay-performance sensitivity was too low; CEO compensation increased by a mere \$3.25 for every \$1,000 increase in shareholder wealth. Citing this result, agency theorists called for greater pay-performance sensitivity and more effective incentive alignment, most notably by using stock options and other equity-based compensation plans.

Taken together, monitoring and incentive-alignment mechanisms aim to strengthen shareholders' power and control over management. The explicit rationale behind the shareholder power argument is to minimise managers' potential to waste company assets and to maximise shareholder wealth. Implicit in the argument is that maximisation of shareholder wealth is the primary goal of public corporations. Agency theorists argue that shareholders are the residual claimants of the corporations (Fama and Jensen, 1983). Since shareholders receive the residual gain from the business and bear the residual risk associated with the corporate enterprise, they have the greatest incentives to ensure efficient operation of the company. Therefore, the argument goes, maximising shareholder value is equivalent to maximising the value of corporations, and it should be the most important goal of corporations (Jensen, 2001; Sundaram and Inkpen, 2004).

Since the two mechanisms – monitoring and incentives – generally aim to achieve the common goal of strengthening shareholder power and maximising shareholder value, I formulate two hypotheses that link governance mechanisms and executive compensation.

Hypothesis 1. The level of CEO compensation is lower at firms with greater monitoring abilities and a greater use of incentive compensation than at firms with less monitoring abilities and less use of incentive compensation.

Hypothesis 2. The sensitivity of CEO compensation to firm performance is greater at firms with greater monitoring abilities and a greater use of incentive compensation than at firms with less monitoring abilities and less use of incentive compensation.

III AN INSTITUTIONAL PERSPECTIVE: SYMBOLIC MANAGEMENT AND REWARDS FOR CONFORMITY

While agency theory is dominant in the literature, there are scholars who question the theory. First, critics argue that board monitoring has not been effective in reality. Even with an increased number of outsiders, directors on boards are still under considerable influence from management. Studies have found that social, psychological, and political dynamics between directors and executive managers often affect director behaviours and the functioning of the board (Bebchuk and Fried, 2004; O'Reilly and Main, 2010; Wade, O'Reilly, and Chandratat, 1990). Institutional investors, on the other hand, may also have limited influence over the actual decision-making process of corporations. Davis (2008) illustrated that even the largest mutual funds are reluctant to exercise influence over corporate management. Contrary to agency theory's prediction, Hartzell and Starks (2003) found that the level of institutional ownership is positively associated with the level of executive compensation at S&P 1,500 firms. This suggests that despite the call for strengthening external monitoring, corporate executives still maintain a considerable degree of discretion and influence over the executive pay settings (Bebchuk and Fried, 2004).

To agency theorists' disappointment, the actual evolution of executive compensation has not been very responsive to the corporate governance reforms that strengthened monitoring and incentive alignment. While major corporations have increasingly appointed more and more outside directors and increased institutional investor ownership, the level of executive compensation has continued to rise, except for the brief period after the burst of the dot-com bubble in the early 2000s (Bebchuk and Grinstein, 2005). Despite a greater use of incentive pay systems such as restricted stock grants and stock options, the sensitivity of pay to performance has remained disappointingly low (Tosi, Werner, Katz, and Gomez-Mejia, 2000). Excessive pay packages for executives at poorly performing companies have often become headline news.

To account for the continued rise of executive pay despite governance reforms, I propose an alternative explanation. It draws from two related thoughts in organisational theory: (1) decoupling of institutionalised practice from the actual implementation of the practice, and (2) symbolic management of external constituencies. First, neo-institutional theory suggests that organisations often adopt new practices and policies not from internal motivation to innovate and change, but from external influence (Meyer and Rowan, 1977; DiMaggio and Powell, 1983). When organisations adopt new practices due to such external forces, they tend to eschew total commitment to the new practices. Rather, organisations seek ways to preserve many of its

own characteristics from the past, while presenting the appearance of change. Meyer and Rowan (1977) called this “decoupling” of formal structures from actual activities. Empirical studies demonstrated that the adoption of a new practice is often decoupled from its implementation (for a review, see Bromley and Powell [2012]). For example, Westphal and Zajac (1994) found that firms often announce the adoption of long-term incentive plans for executive managers, but do not actually implement them. In a similar manner, adoption of monitoring mechanisms may have also been decoupled from implementation. Indeed, Westphal and Zajac (1998) showed that firms that successfully decouple the adoption of long-term incentive plans from its implementation often avoid board reforms, including the appointment of outside directors.

Second, related to the idea of decoupling, firms often adopt new practices in order to gain approval from important external constituencies. Such efforts are focused on symbols and appearances rather than objective criteria (Pfeffer, 1981). Symbolic management delivers considerable benefits to the firm, including greater legitimacy and a better reputation (Elsbach, 1994; Staw and Epstein, 2000). Consistent with this idea, Zajac and Westphal (2004) showed that the stock market reacts favourably to firms that adopt share repurchase plans as a mechanism to increase shareholder value. Valuation is significantly affected by the appearance of legitimacy, as Zuckerman (1999) demonstrated that market valuation of the firms is shaped by the stock analysts’ perception of legitimacy. The appearance of legitimacy, rather than objective metrics, is even more important in the valuation of executive skills, because it is difficult to determine how much changes in firm performance can really be attributed to top management (Liebersohn and O’Connor, 1972; Pfeffer, 1977). As March (1984) suggested, ambiguity in evaluating managerial ability on the basis of firm performance may stimulate the management of accounts and reputation through symbolic management (Wade, Porac, and Pollock, 1997; Westphal and Zajac, 1998).

The ideas of decoupling and symbolic management suggest that firms may adopt monitoring and incentive-alignment mechanisms due to the pressure from external constituencies such as institutional investors, fund managers, and stock analysts who generally espouse shareholder value orientation. The adoption of new governance mechanisms provides the firms with symbolic legitimacy and a better reputation among the external constituencies. However, firms engage in decoupling strategies to limit the impact of new governance mechanisms, so the actual effect of monitoring and incentives is minimal.

With successful decoupling and symbolic management, executives at the firms with stronger governance mechanisms are perceived as more competent and trustworthy in the eyes of the directors and investors. As a consequence,

executive compensation is greater at the firms that instituted monitoring and incentive-alignment mechanisms. In this sense, greater executive pay is a form of rewards for the executives who conformed to shareholder value orientation. The board members, particularly those who sit on the compensation committee, may believe that such a reward is necessary to retain valuable executive talent, since the directors may feel that the shareholder value oriented CEOs are in great demand in the executive labor market. If the compensation committee of the board acts on this perceived need for rewarding the executives, CEO compensation is expected to increase subsequent to the adoption of and improvement in the governance mechanisms, controlling for any changes in firm performance and in any other determinants of executive compensation. Following this logic, two hypotheses are proposed. Note that Hypothesis 3 is an alternative hypothesis of Hypothesis 1, an agency-theoretic prediction.

Hypothesis 3. The level of CEO compensation is higher at firms with greater monitoring abilities and a greater use of incentive compensation than at firms with less monitoring abilities and less use of incentive compensation.

Hypothesis 4. Firms that strengthen their monitoring abilities and increase the use of incentive compensation increase the executive pay in the subsequent time period.

IV DATA AND METHODS

To test these hypotheses, I analysed compensation data for 290 CEOs from US firms for the period of 1996–2006. Due to the regulatory changes in the Securities and Exchange Commission (SEC) requirements for executive compensation disclosure, where the compensation data for this study come from, post-2006 compensation data are not compatible with the data for the earlier period. The 11-year period (1996–2006) spans both economic boom and bust: the dot-com boom and bust, the 2001 recession, and the subsequent boom. To construct the sample, the largest (by revenue) 200 publicly traded companies were selected from the *Fortune 500* list for each year of the study period. In total, 290 firms appeared on the list. I selected 272 firms that appeared in the sample a minimum of three years. The analysis excluded 51 firms in finance, insurance, and real estate (Standard Industrial Classification [SIC] codes 60-67), because the purpose of the study is to analyse the behaviour of non-financial firms as the main actors of financialisation (Krippner, 2005).

Two firms were dropped because their primary industry could not be classified (SIC code 99). After excluding the firms that do not have complete information on all variables, the final sample included 178 firms, or 960 firm-year observations. The t-tests suggest that total sales and the number of employees are not significantly different at the 5 per cent level between the final sample and the non-selected top-200 firms on the *Fortune* lists. Two hundred and ninety CEOs led the sample firms during the study period. In some models, the number of observations is smaller due to missing values.

The dependent variable in the regression models is CEO compensation, defined as the logarithm of the total amount of annual compensation for each CEO. The compensation measure includes salary, bonuses, the Black-Scholes value of stock option grants, restricted stock grants, and long-term incentive plans. The regression models use the logarithm of the compensation to reduce the impact of extreme values.

The key independent variable is the monitoring and incentive-alignment mechanisms. To construct a measure that effectively summarises the joint effect of the disparate mechanisms, I used factor analysis to combine several indicators of shareholder value orientation. Initially, the factor analysis included a wide selection of variables that broadly represent shareholder value orientation, such as the percentage of company shares held by institutional investors, the Herfindahl measure of concentration of institutional ownership, the percentage of institutional ownership held by the top-five investors, the percentage of outsiders on the board of directors, the percentage of incentive pay (i.e., compensation components that are contingent on future performance) in the CEO compensation package, the amount of dividends per share, and the number of business segments in different three-digit SIC industries. Dividends payout represents the firm's direct distribution of corporate profits to shareholders (Lazonick and O'Sullivan, 2000; Julio and Ikenberry, 2004). The number of business segments measures the level of corporate diversification, which has become the target of criticism as shareholder value proponents advocated for refocusing on core competencies (Davis *et al.*, 1994; Zuckerman, 2000).

Table 1 presents the result of a principal-components factor analysis with a Varimax rotation. Each variable loads unambiguously on a single factor at 0.60 or greater. The first factor represents the concentration of institutional ownership: Herfindahl measure of institutional ownership concentration and the percentage of institutional ownership held by the top-five investors. Not surprisingly, these two variables are designed to measure a common concept: the concentration of institutional ownership. The second factor summarises the monitoring and incentive-alignment mechanisms: institutional ownership (percentage of shares held by institutional investors), board independence

Table 1: *Results of Principal-Components Factor Analysis with Varimax Rotation*

	<i>Factor 1</i>	<i>Factor 2</i>	<i>Factor 3</i>
Herfindal measure of concentration of institutional ownership	0.96	-0.05	-0.03
% institutional ownership held by top-5 investors	0.96	0.05	-0.05
% shares held by institutional investors	0.14	0.67	-0.31
% outside directors on the board	-0.04	0.71	0.34
% incentive pay in CEO pay package	-0.11	0.61	-0.05
Dividends per share	-0.08	-0.05	0.79
Number of segments in 3-digit SIC	-0.05	0.11	0.71
Eigenvalue	1.97	1.36	1.24
Proportion of variance accounted for	0.28	0.19	0.18

(percentage of outside directors), and incentive pay (percentage of incentive pay in the CEO compensation package). Factor 3 consists of dividends and the level of diversification. Among these three factors, Factor 2 is used to construct an index that represents monitoring and incentive alignment, which is labelled *shareholder value orientation index*. This index is used as the main independent variable for hypothesis testing. When the components of this index are entered into the models separately, the results remain substantively similar. The components of the other two factors (Factors 1 and 3) are included in the regression as control variables. Because the Herfindahl index of institutional ownership and the percentage of top-five investors are highly correlated, only the top-five-investors measure is entered in the models.

The models include several control variables. A CEO's tenure on the job and the status as board chair are included to control for the CEO's potential power and influence over the board. Studies have shown that these indicators of CEO power are significantly related to the level and the structure of CEO compensation (Hill and Phan, 1991; van Essen *et al.*, 2012). A CEO's functional background represents the CEO's cultural and cognitive characteristics, which may indicate the conceptions of control that is dominant at the firm (Fligstein, 1990). Having a certain background, particularly in finance and accounting, may predispose the managers to finance-oriented management tactics and shareholder-oriented governance mechanisms (Jensen and Zajac, 2004). The predominant functional background of a CEO's professional education (e.g., advanced degree in law or medicine) and early career (e.g., first job in a marketing department) is coded into five categories: (1) general management (including operation and administration), (2) finance, (3) sales and marketing,

and (4) technical (e.g., engineering, medicine, etc.). General management is the reference category omitted in the regression models. CEOs recruited from outside the firm start the job with a considerable bonus (Fee and Hadlock, 2003; Elsaid and Davidson, 2009), so I control for such cases using an indicator variable for outsider CEOs. Studies have repeatedly demonstrated that firm size and performance affect executive compensation (Tosi *et al.*, 2000). Firm size is measured in a logarithm of total sales. For firm performance, both accounting and market measures are used: return on assets (ROA) and one-year total shareholder returns. The shareholder returns measure is computed by dividing the sum of the change in stock price and dividends paid during the year by the stock price at the beginning of the year. Dividends per share and diversification level (measured by the number of business segments in different 3-digit SIC industries) are the other indicators of shareholder value orientation that were not captured in the construction of the shareholder value orientation index. These two variables are entered into the model as controls. I also control for the concentration of institutional ownership (measured by the percentage of institutional ownership held by top-five investors), because this is not included in the construction of shareholder value orientation index. All dollar values are adjusted for inflation using the Consumer Price Index. Table 2 presents means, standard deviations, and Pearson's correlation coefficients for all variables.

Information on CEO compensation and characteristics came from Standard and Poor's ExecuComp database. Financial and operational data at the firm level came from various sources including Compustat, Mergent Online, company annual reports, and various corporate directories. Board composition data came from RiskMetrics Directors dataset and proxy statements. The information about institutional shareholding came from Thomson Financial's 13f Institutional Holdings (CDA/Spectrum s34) data. Finally, the CEOs' functional backgrounds were manually collected from various sources including *Dun and Bradstreet Reference Book of Corporate Managements*, *Who's Who in Finance and Industry*, and executive biographies in *BusinessWeek* and *Forbes*.

The panel data consist of annually repeated observations for each firm. The unit of analysis is the firm-years. Because the annual observations from the same firm are likely to be correlated, the OLS regression would violate the assumption of independent observations. Therefore, random-effects regressions with robust standard errors are estimated. A random-effects model decomposes the error terms into the part that is unique to the firms and the part that is unique to the firm-years. Because a random-effects model uses the information about the variations within the firms across different time periods and the variations between the firms, it is more efficient than a fixed-effects

Table 2: Means, Standard Deviations and Correlations

	Mean	S.D.	1.	2.	3.	4.	5.	6.	7.	8.	9.	10.	11.	12.	13.	14.	15.	16.	17.
1. CEO compensation (logged)	8.96	0.87																	
2. CEO tenure (in years)	7.33	6.42	-0.06																
3. CEO is chair (binary)	0.80	0.40	0.11*	0.22*															
4. CEO background: general (binary)	0.49	0.50	0.03	-0.02	0.06*														
5. CEO background: finance (binary)	0.12	0.32	-0.01	-0.09*	-0.02	-0.36*													
6. CEO background: marketing and sales (binary)	0.21	0.40	-0.01	0.03	-0.13*	-0.50*	-0.19*												
7. CEO background: technical (binary)	0.19	0.39	-0.01	0.07*	0.07*	-0.47*	-0.18*	-0.25*											
8. Outsider CEO (binary)	0.21	0.41	0.00	0.15*	0.06	0.02	-0.01	-0.05	0.03										
9. Sales (logged, 1-year lagged)	9.89	0.67	0.24*	-0.12*	-0.04	-0.04	0.03	-0.08*	0.11*	0.00									
10. ROA (logged, 1-year lagged)	0.05	0.05	0.09*	0.08*	-0.06	-0.04	-0.06	0.11*	-0.01	-0.09*	0.05								
11. Total shareholder returns	0.01	0.39	-0.01	0.03	0.04	-0.03	0.04	-0.03	0.04	-0.05	-0.06	-0.10*							
12. Dividends per share (1-year lagged)	0.76	0.71	-0.01	-0.10*	0.17*	-0.04	0.01	-0.11*	0.15*	-0.12*	0.07*	-0.01	-0.05						
13. Number of segments in different 3-digit SICs (1-year lagged)	2.13	1.15	0.14*	0.07*	0.08*	0.14*	-0.05	-0.16*	0.03	-0.04	0.15*	-0.14*	-0.01	0.24*					
14. Institutional ownership concentration (% institutional ownership held by top-5 investors, 1-year lagged)	34.07	9.73	-0.16*	0.06	0.05	-0.01	0.06	-0.01	-0.02	0.11*	-0.19*	-0.38*	0.09*	-0.11*	-0.09*				
15. % shares held by institutional investors (1-year lagged)	63.91	14.83	0.05	0.02	0.03	-0.04	0.08*	0.06	-0.08*	-0.02	-0.16*	-0.11*	-0.01	-0.17*	-0.03	0.15*			
16. % outside directors (1-year lagged)	69.86	15.75	0.16*	-0.10*	0.24*	0.05	-0.02	-0.15*	0.11*	-0.09*	0.09*	-0.05	0.06	0.18*	0.16*	-0.01	0.18*		
17. % incentive pay in CEO pay package (1-year lagged)	61.31	24.36	0.30*	-0.06	0.06*	-0.05	-0.04	0.03	0.07*	-0.09*	0.09*	-0.03	-0.08*	-0.02	0.04	-0.07*	0.06	0.17*	
18. Shareholder value orientation index (factor scale, 1-year lagged)	-0.10	0.99	0.25*	-0.08*	0.18*	-0.01	0.01	-0.04	0.05	-0.10*	0.02	-0.10*	-0.01	0.01	0.10*	0.03	0.62*	0.74*	0.59*

* p< 0.05.

model that relies only on variations within the firms. Since the key independent variable, shareholder value orientation index, exhibits little variation over time, a fixed-effects model would not be appropriate to capture variations both within the firm over time and between the firms. The variables whose values rarely change over time, such as CEO/chair duality, CEO background, and outsider CEO, cannot be entered in the fixed-effects models. A Hausman test suggests that the coefficient estimates between fixed-effects and random-effects models are not systematically different at the 5 percent level, which justifies the use of random effects. When the models are estimated using OLS regression with robust standard errors or generalised linear models (GLM) with one-year autocorrelation, the substantive findings remain unchanged. To test whether any specific firms, industries, or years bias the estimates, jackknife analysis is conducted by excluding one firm, industry, or year at a time. The results, available upon request, are substantively similar to those presented in this paper.

V RESULTS

Table 3 presents the results of the random-effects regression models predicting the level of annual CEO compensation. All independent variables are lagged by one year, except for CEO tenure, CEO/chair duality, and CEO background, which are stable over time or linearly related to the time. Model 1 is the baseline model. To test Hypotheses 1 and 3, Models 2 to 4 add three variables that represent shareholder value orientation: institutional ownership (percentage of shares held by institutional investors), board independence (percentage of outside directors), and incentive pay (percentage of CEO pay that is contingent on firm performance). Drawn from the agency theory, Hypothesis 1 predicted that the level of CEO compensation is lower at firms with greater monitoring abilities and a greater use of incentive compensation than at firms with less monitoring abilities and less use of incentive compensation. Alternatively, Hypothesis 3 suggested that the level of CEO compensation is higher at firms with greater monitoring abilities and a greater use of incentive compensation. The results suggest that institutional ownership and incentive pay are positively and significantly related to the level of CEO compensation, whereas the percentage of outside directors is not significantly associated with the level of CEO compensation. For two out of the three indicators of shareholder value orientation, the results support Hypothesis 3 rather than Hypothesis 1.

Instead of the three separate indicators, Model 5 uses the independent variable *shareholder value orientation index* which was constructed from the

factor analysis. The variable *shareholder value orientation index* represents the strength of monitoring and incentive alignment. Contrary to Hypothesis 1, CEO compensation is greater at firms with a higher value of shareholder value orientation. This supports the alternative hypothesis, Hypothesis 3. This suggests that firms with shareholder value orientation mechanisms – such as monitoring and incentive alignment – do not effectively curb executive compensation. On the contrary, such firms pay their CEOs more than did other firms. This result is consistent with the argument that firms espouse shareholder value orientation not to limit managerial power, but to gain approval and legitimacy in the eyes of those who evaluate the quality of top management. This is not due to the possibility that firms with shareholder value orientation may have higher firm performance, thereby increasing the value of equity-based compensation for the executives, because the model controls for firm performance both in accounting and market metrics. Model 6 adds dummy variables for year and 2-digit SIC industries, whose coefficients are not presented due to space constraints. The results are substantively similar to those of Model 5.

Turning to the test of Hypotheses 2 and 4, random-effects models are estimated to predict annual changes in CEO compensation from year $t-1$ to t . Table 4 presents the results. Since the dependent variable is the change between two years, the models include both the level and the annual changes in the independent variables. The change in CEO tenure is not included because every year, CEO tenure increases by one. Shareholder returns variable is not transformed into the annual change form, because the definition of shareholder returns already includes the changes in stock price between two years. The models include a dummy variable for CEOs recruited from outside the firm.

Models 1 to 4 in Table 4 test Hypothesis 2, which predicted that firms with shareholder value orientation – measured by greater monitoring abilities and a greater use of incentive compensation – have a greater pay-performance sensitivity than do other firms. This was drawn from the agency theory. I test this hypothesis by using interaction terms between firm performance and the shareholder value orientation index. Models 1 and 2 use an accounting measure of performance: ROA. In Models 3 and 4, a market-based measure is used: total shareholder returns. Models 2 and 4 add dummy variables for year and 2-digit SIC industries. In Models 1 to 4, the interaction terms are not statistically significant, contrary to agency theory's prediction (Hypothesis 2). Models 5 and 6 test Hypothesis 4, which was drawn from an alternative explanation based on the idea of institutional decoupling and symbolic management. Model 6 includes dummy variables for year and 2-digit SIC industries. Supporting Hypothesis 4, CEO compensation increases subsequent

Table 3: *Random-Effects Regression Predicting the Level of CEO Compensation^a*

	<i>Model 1</i>	<i>Model 2</i>	<i>Model 3</i>	<i>Model 4</i>	<i>Model 5</i>	<i>Model 6</i>
CEO tenure	-0.01 (0.01)	-0.01 (0.01)	-0.01 (0.01)	-0.01 (0.01)	-0.01 (0.01)	0.00 (0.01)
CEO is chair	0.07 (0.12)	0.06 (0.13)	0.02 (0.13)	0.08 (0.11)	0.05 (0.11)	0.00 (0.11)
CEO background (omitted: general background)						
Finance background	-0.10 (0.10)	-0.10 (0.11)	-0.12 (0.10)	-0.09 (0.09)	-0.10 (0.10)	-0.05 (0.10)
Marketing & sales background	-0.09 (0.10)	-0.09 (0.10)	-0.09 (0.10)	-0.08 (0.10)	-0.09 (0.10)	-0.05 (0.10)
Technical background	-0.09 (0.09)	-0.08 (0.09)	-0.13 (0.09)	-0.09 (0.09)	-0.10 (0.10)	-0.10 (0.10)
Outsider CEO	0.28 * (0.11)	0.27 ** (0.10)	0.26 * (0.11)	0.27 ** (0.10)	0.27 * (0.11)	0.30 ** (0.11)
Sales	0.27 ** (0.06)	0.28 ** (0.07)	0.27 ** (0.06)	0.24 ** (0.06)	0.27 ** (0.07)	0.37 ** (0.08)
ROA	1.47 (1.60)	0.94 (1.52)	1.72 (1.62)	1.80 (1.50)	0.92 (1.61)	0.44 (1.62)
Total shareholder returns	0.13 (0.11)	0.15 (0.11)	0.12 (0.11)	0.13 (0.09)	0.07 (0.08)	0.10 (0.08)
Dividends per share	-0.11* (0.05)	-0.09 (0.06)	-0.12* (0.05)	-0.11* (0.05)	-0.12* (0.05)	-0.16** (0.05)
Number of segments	0.11** (0.03)	0.10** (0.03)	0.10** (0.03)	0.10** (0.03)	0.09** (0.03)	0.04 (0.04)
Institutional ownership concentration	0.00 (0.00)	-0.01* (0.00)	0.00 (0.00)	0.00 (0.00)	-0.01+ (0.00)	0.00 (0.00)
% institutional ownership		0.01** (0.00)				
% outside directors			0.00 (0.00)			
% incentive pay				0.01** (0.00)		
Shareholder value orientation index					0.13 ** (0.04)	0.14 ** (0.04)
Year dummies						Included
Industry dummies						Included
Constant	6.15** (0.64)	5.55** (0.70)	5.93** (0.63)	6.24** (0.59)	6.44** (0.70)	6.32** (1.01)
Number of observations	953	925	934	947	850	850
R ²	0.06	0.09	0.07	0.13	0.12	0.29

^aNumbers in the parentheses are robust standard errors.

** p < .01, * p < .05, + p < .10 (two-tailed tests).

Table 4: *Random-Effects Regression Predicting the Annual Changes in CEO Compensation^a*

	<i>Model 1</i>	<i>Model 2</i>	<i>Model 3</i>	<i>Model 4</i>	<i>Model 5</i>	<i>Model 6</i>
CEO tenure	-0.01 (0.01)	-0.01 (0.01)	-0.01 (0.01)	-0.01 (0.01)	0.00 (0.00)	0.00 (0.00)
Outsider CEO	0.00 (0.09)	0.01 (0.09)	0.01 (0.09)	0.01 (0.09)	-0.02 (0.04)	0.00 (0.04)
Sales	0.01 (0.03)	0.01 (0.04)	0.01 (0.03)	0.01 (0.04)	-0.01 (0.02)	0.04* (0.02)
ΔSales	0.18 (0.19)	0.11 (0.19)	0.19 (0.19)	0.12 (0.19)	0.41** (0.13)	0.44** (0.14)
ROA	-1.04 (1.59)	-1.22 (1.77)	-1.05 (1.58)	-1.21 (1.77)	0.02 (0.34)	0.72 (0.45)
ΔROA	1.42 (1.02)	1.17 (0.99)	1.34 (1.03)	1.11 (0.99)	0.57 (0.86)	0.74 (0.85)
Total shareholder returns	0.20* (0.09)	0.24* (0.10)	0.17 + (0.09)	0.23* (0.10)	0.13* (0.07)	0.15 + (0.08)
Institutional ownership concentration	-0.01 (0.00)	0.00 (0.00)	-0.01 (0.00)	0.00 (0.00)	0.00* (0.00)	0.00 (0.00)
ΔInstitutional ownership concentration	-0.02** (0.01)	-0.01** (0.01)	-0.02** (0.01)	-0.01** (0.01)	-0.01** (0.00)	-0.01* (0.00)
Shareholder value orientation index	-0.25** (0.03)	-0.27** (0.04)	-0.25** (0.03)	-0.28** (0.04)	-0.01 (0.02)	0.03+ (0.02)
ΔROA x Shareholder value orientation index	0.75 (1.25)	0.71 (1.22)				
Total sharehold returns x Shareholder value orientation index			-0.04 (0.05)	-0.02 (0.05)		
Δ(Shareholder value orientation index)					0.76** (0.05)	0.83** (0.05)
Year dummies		Included		Included		Included
Industry dummies		Included		Included		Included
Constant	0.21 (0.34)	0.72 (0.44)	0.21 (0.34)	0.75 + (0.44)	0.15 (0.21)	-0.59* (0.25)
Number of observations	960	960	960	960	936	936
R ²	0.08	0.11	0.08	0.11	0.40	0.45

^aNumbers in the parentheses are robust standard errors.

** p < 0.01, * p < 0.05, + p < 0.10 (two-tailed tests).

to the increase in the shareholder value orientation index. This suggests that when a firm strengthens governance mechanisms that aim to maximise shareholder value, the CEO is financially rewarded in the subsequent year, controlling for the changes in performance. Such a pay raise is hard to interpret as incentive alignment, as agency theorists would argue. For this to

be true incentives for better performance, CEO pay raises should be associated with increases in firm performance. This was not the case, as Hypothesis 2 was not supported (see Models 1 to 4 in Table 4). Rather, it is more plausible to view this raise as a reward for CEOs who adopt shareholder value orientation and thus gain shareholder approval and external legitimacy.

VI DISCUSSIONS AND CONCLUSION

This study has several important contributions. First, at the more general level, the findings of this study shed light on the financialisation of the US economy. The sources of financialisation have often been attributed to societal- or institutional-level changes such as deregulation and neo-liberal public policies (Krippner, 2011; Tomaskovic-Devey and Lin, 2011). Whereas there is no doubt that such macro-level changes played crucial roles, the actual process of financialisation in non-financial firms was undertaken by the firms and, more precisely, their top decision makers. Without understanding the motives and incentives of these key actors of financialisation, it is difficult to reconcile the paradox that shareholder value reforms challenging managerial power coincided with the continuous increase in managerial income (Goldstein, 2012). Corporate executives participated in the parallel processes of both financialisation and the shareholder value revolution. By carrying out the shareholder value mantra, the executives have redistributed corporate resources and profits away from traditional business and toward finance-related activities such as mergers and acquisitions, leveraged buyouts, and stock repurchases (Davis *et al.*, 1994; Fligstein, 2001; Zajac and Westphal, 2004). For this, they were handsomely rewarded.

Second, the study offers an explanation for the continuing rise in executive compensation despite the widespread adoption of governance reforms that aimed to strengthen monitoring and incentive alignment. Whereas financial economists and activist investors have advocated adopting governance mechanisms that strengthen monitoring and incentive alignment, executive compensation has continued to rise without a strong link to performance. Here, I proposed an alternative explanation that firms adopt monitoring and incentive-alignment mechanisms in order to gain the appearance of shareholder value orientation. By employing such symbolic management tactics, top managers at such firms earn legitimacy and a better reputation in the eyes of those who favourably evaluate executive managers. In the empirical analysis, I demonstrated that CEOs at the firms with the appearance of shareholder value orientation – such as monitoring and incentive-alignment mechanisms – received greater pay packages than did

other CEOs with weaker shareholder value orientation. In addition, when the firms strengthened the appearance of shareholder value orientation, CEO pay increased in the subsequent year, controlling for any changes in performance. These findings suggest that the firms were subject to significant pressure to conform to the shareholder value orientation, but top executives were strategic enough to manage symbolically the external, institutional pressures to their advantage. Governance mechanisms that aimed to strengthen shareholders' power and control over the management were largely decoupled from the practice. Executives maintained, and in some sense strengthened, their power and discretion by espousing the dominant business principle of shareholder value maximisation. Even though the shareholder value ideology was initially proposed to curb managerial power, it may have paradoxically provided powerful managers with a symbolic and rhetorical tool for accumulating personal wealth. This may explain a significant part of the rise in CEO compensation. Together with the recent studies that demonstrate how compensation benchmarking among peer firms leads to a dramatic rise in CEO pay over time (DiPrete *et al.*, 2010; Faulkender and Yang, 2010), the present study underscores the behavioural and institutional sources of the rise in CEO compensation.

Third, the findings of this study suggest how prescriptions from an economic theory, particularly agency theory, were strategically adopted and misapplied by firms. Agency theory provides normative prescriptions about how to reduce agency cost and maximise efficiencies. Although the theory may correctly state what firms should do, it fails to describe what American firms actually do, as I demonstrate in this paper. I argue that American firms followed agency theorists' prescriptions and adopted governance practices that are supposed to reduce agency cost and maximise shareholder value, but their adoptions were largely symbolic and decoupled from actual effectiveness. Dobbin and Jung (2010) recently made a similar argument: American companies selectively adopted agency theory's prescriptions, embracing strategies that increased firm risks while failing to adopt practices such as board reforms that moderate risks. The current study complements this argument and suggests that top managers who adopted agency theory's prescriptions in a symbolic way were financially rewarded. This implies that the academic theory clearly went beyond the academia and provided a symbolic tool for top executives who realised the predominance of shareholder value ideology and gained financially for showing their conformity to the dominant ideology.

The study has significant implications for institutional theory as well. Institutional pressures such as the shareholder value principle may exist in the organisational field, but the adoption and implementation of new

organisational forms and practices require a substantial degree of power and resource mobilisation within the organisations. The shareholder value revolution aimed to curb managerial power that has prevailed in the American corporations for decades since Berle and Mean's (1932) managerialism thesis, but the power and privileges of executive managers as corporate elites turned out to be formidable. Powerful CEOs do not passively conform to institutional pressures, as the original proposition of institutional theory may imply. Instead, they are politically savvy and resourceful enough to align their rhetorical positions and material interests with the new dominant discourse of the time. Such an account of powerful actors highlights the political as well as strategic nature of institutional processes, as argued in Oliver (1991) and Porac, Wade, and Pollock (1999).

Several limitations of this study suggest avenues for future research. First, the presence of shareholder value orientation was inferred from indirect indicators rather than from direct observation of executive behaviour or attitudes. Innovative research methods, perhaps a combination of qualitative and quantitative approaches, are needed. Second, the sample was limited to the largest firms. It is still unknown whether and how shareholder value orientation has diffused across mid-size and small firms. Third, this study focused on the period of 1996–2006. Whereas the 11-year period is long enough for a longitudinal analysis, future research should examine an even longer timespan (perhaps from the late 1970s) to cover the entire evolution of shareholder value orientation. It is also important to examine how the recent financial crisis and recession affected shareholder value orientation. Finally, parallel studies should be done in non-US settings. Corporate governance systems vary significantly across countries (Aguilera and Jackson, 2010). There has been considerable debate about the convergence and divergence of corporate governance systems across different countries (Cheffins, 2003; Hansmann and Kraakman, 2001). A cross-national analysis of financialisation and shareholder value orientation would be immensely valuable.

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